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(5)

No. 93-823

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

—v.—

JOHN LOEWENSTEIN,

Respondent.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF NEBRASKA

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE FEDERAL RESERVE BANK OF NEW YORK

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Motion for Leave to File Brief *Amicus Curiae* and Brief *Amicus Curiae* of the Federal Reserve Bank of New York.

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The Federal Reserve Bank of New York ("New York Fed") respectfully moves for leave to file the attached *amicus curiae* brief. The consent of the attorney for the petitioner has been obtained. The consent of the attorney for the respondent was requested but refused.

The New York Fed has two interests in this case. The Nebraska Supreme Court relied heavily on inferences drawn from testimony given by Peter D. Sternlight, a retired executive vice president of the New York Fed. The New York Fed does not believe that the testimony supports these inferences, and wishes to express an official position on repurchase agreements and their significance to the government securities market. Second, the New York Fed is concerned about the possibility of inadvertent dicta in this case, that could adversely affect the depth and liquidity of the government securities market.

These interests are distinct from those of the parties, who are principally concerned with the taxability of income arising from repurchase transactions. Furthermore, the New York Fed believes that its considerable expertise in repurchase transactions and their role in the government securities market may be of assistance to the Court.

Respectfully submitted,

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Statement of Interest

The Federal Reserve Bank of New York ("New York Fed") submits this *amicus curiae* brief to assist the Court in understanding repurchase agreements ("repos" or "repo transactions"), to explain the importance of repos in the money market, and to avoid possible destructive consequences of a decision stating that repos are secured loans. An improper characterization of the repo transaction may unintentionally disrupt their intended operation under state commercial law and cause many governmental and quasi-governmental organizations to withdraw from this important sector of the nation's money market. The result would be a far less liquid market, to the detriment of those who remain eligible to participate, and with adverse effects on fiscal policy.

The New York Fed is also concerned about being misinterpreted. The Nebraska Supreme Court relied heavily on inferences drawn from testimony given by Peter D. Sternlight, a now-retired executive vice president of the New York Fed.[1] Although we endorse Mr. Sternlight's testimony, we believe that some of the inferences drawn from this testimony by the Nebraska Supreme Court are unwarranted.

Summary of Argument

This is a state tax case arising under 31 U.S.C. § 3124. Most of the courts that have considered the state taxability of repo income have resolved the issue by engaging in a characterization exercise: are repos "secured loans" or "sales and repurchases"? This characterization is outcome determinative: if secured loans, the income produced is subject to state taxation.

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[1] We understand that this deposition testimony, and an attached affidavit, are in the Joint Appendix. We shall be citing the affidavit in this brief without the benefit of the Joint Appendix pagination, which is prepared by the parties. We therefore attach the affidavit as an appendix to this brief.

The New York Fed is concerned with the possible effects of this characterization exercise. If repos are broadly characterized by this Court as secured loans, the market in government securities might lose much of its depth and liquidity.

Fortunately, this case may be decided without characterizing the nature of a repo. We urge this Court to decide this case consistently with its prior construction of 31 U.S.C. § 3124, which does not involve characterization of the underlying transaction, but rather explores the economic impact of a state tax on the underlying government securities.

The Nebraska Supreme Court applied the correct legal standard, and tried to explore the economic impact of the state tax. But its economic analysis hinged on the meaning of Mr. Sternlight's testimony. The New York Fed can find nothing in Mr. Sternlight's testimony that supports the meaning given it by the Nebraska Supreme Court. A more appropriate analysis of economic impact may well be consistent with the Nebraska Supreme Court's outcome, or it may not. But Mr. Sternlight's testimony, although correct in all respects, is not relevant to economic impact of state taxation and should not be part of this Court's analysis.

The New York Fed has a strong interest in this Court's analysis of this case but has no interest in the outcome. We, therefore, depart from customary practice and file this *amicus* brief on behalf of neither party. The New York Fed's interest is confined to clarifying the meaning of Mr. Sternlight's testimony and ensuring that this Court avoid an unnecessary or overly broad characterization of the repo transaction.

Argument

We begin with a description of the repo transaction and the role of this transaction in the government securities market.

Repos are generally structured as a contract for the sale (or purchase) of a security, subject to a simultaneously created forward agreement for the repurchase (or resale) of the same

or a similar security at an agreed date.[2] *See SEC v. Drysdale Secur. Corp.*, 785 F.2d 38, 41 (2d Cir.), *cert. denied sub nom. Essner v. SEC*, 476 U.S. 1171 (1986); Affidavit of Peter D. Sternlight, April 11, 1986, at ¶¶ 1-3 (hereinafter "Sternlight Affidavit"). Repos are over-the-counter transactions, sometimes brokered and sometimes entered into directly between parties. The expression "repurchase agreement" actually encompasses two separate market transactions—the repo and the reverse repo. They are in essence the same transaction viewed from different perspectives. A repo is a transaction in which securities are sold subject to an agreement to repurchase; a reverse repo (or "reverse") is to a transaction in which securities are bought subject to an agreement to resell.

We fully agree with the portion of Judge Debevoise's anaysis of the repo excerpted below. *In re Bevill, Bresler & Schulman Asset Management Corp.*, 67 Bankr. 557, 566-67 (D.N.J. 1986) ("*BBS*"). Judge Debevoise wrote:

> A standard repo consists of a two-part transaction. The first part consists of the transfer of specified securities by one party, the seller, to another party, the buyer, in exchange for cash. The second part consists of the contemporaneous agreement by the seller to repurchase the securities at the original price, plus an agreed upon amount of interest, on a specified future date. . . . A standard reverse repo consists of the same two-part transaction viewed from the perspective of the buyer. Thus, when one sells a security and agrees to buy it back, he is engaged in a repo transaction. When the same party buys a security and agrees to sell it back, he is engaged in a reverse repo transaction.

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[2] This case concerns repos in government securities, but repos can be done with any security or other items of value such as bankers' acceptances or even precious metals.

See also Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Sav. & Loan Ass'n, 878 F.2d 742 (3d Cir. 1989) ("*BBS II*").

The repo transaction is extremely liquid because it can afford the holder of the securities the rights of ownership. The holder of the securities:

> take[s] title to the securities received and can trade, sell or pledge them. The repo merely imposes a contractual obligation to deliver identical securities on the settlement date set by the repo contract . . . . the secured lender is free to deal the "collateral."

Drysdale, 785 F.2d at 41. Because a repo is *not* generally structured as a collateralized loan, the holder of the repo securities can sell the securities at will, subject only to the legal obligation to redeliver securities of the same description on the forward settlement date.[3]

This liquidity feature has made repos the principal method of financing positions in government securities. United States Department of the Treasury, Securities and Exchange Commission & Board of Governors of the Federal Reserve System, *Joint Report on the Government Securities Market* A-11 (1992) ("Joint Report"). In effect, repos allow a dealer to use its constantly-changing inventory of government securities to finance its day-to-day operations, without losing any of the dynamism of the inventory. In the course of a single day, a dealer can easily convert a government security to cash through a repo trade, and position the cash in another government security through a reverse repo transaction. This can occur any number of times, permitting dealers to turn over their inventory in response to market conditions, providing the means for creating hedges and arbitrages among various

[3] The New York Fed notes that this description applies to repos that are structured in conformity with general market practice and expectations. Parties can and do structure repos which closely resemble secured loans. These atypical transactions strengthen the New York Fed's main point—characterization of repos is a dangerous process.

issues and thereby increasing the liquidity of the market. Sternlight Affidavit, ¶ 7.

Furthermore, reverse repo transactions serve as low-cost and flexible means of borrowing securities. Borrowed securities are critical in the government securities market, permitting short-selling and ensuring that market participants will be able to complete the securities end of a transaction, avoiding a "fail". If, near the end of day, a market participant finds itself short securities that it is contractually obligated to deliver, it usually obtains these securities on the reverse repo market. *Joint Report*, at A-12.

Repos add not only liquidity to the government securities market, but participants, as well. Corporations, municipalities (including entities such as school districts), financial institutions and pension funds participate in the government securities markets through repo transactions, as well as dealers. *Id.*; Sternlight Affidavit, ¶ 8. Many of these participants, particularly the municipalities, are not empowered to make collateralized loans, but still seek a way of earning interest in a short-term transaction with little or no risk of loss. Accordingly, they may participate in the government securities market through repo transactions only if repo transactions are not characterized as collateralized loans. *Id.*

Statistics reveal the economic significance of repo transactions. A recent figure placed outstanding repos and reverses at $1.5 *trillion*. 80 *Fed. Res. Bull.* A32 (April, 1994). Over $700 billion of this market turns over every day. *Id.*[4] As observed by the court in *BBS II*, 878 F.2d at 742, if the volume of repo transactions were placed next to the volume of transactions in the stock market, the size of the former would easily dwarf the size of the latter.

[4] Both the $1.5 and $0.7 trillion figures were obtained from line items 25-28 of Table 1.43, for the week ending January 19, 1994. The smaller figure is for "overnight and continuing" repo which, in effect, turns over every day, as does some of the term repo.

I. The Depth and Liquidity of the Government Securities Market Would be Impaired by Characterizing Repos as Secured Loans.

Repos are crucial to both the secondary and primary markets in government securities. Repos finance new government debt: the dealers who underwrite new Treasury issues rely heavily on repos pending ultimate resale to investors. Sternlight Affidavit, ¶ 6. As discussed above, repos facilitate a very deep and liquid secondary market for government securities. By promoting liquidity and adding depth in both the primary and secondary markets, repos help lower the interest rate on Treasury obligations, saving funding costs for the Government.

The repo market is supported in significant part by entities with charter or regulatory restrictions that prevent them from making secured loans. These entities lack legal authority to make secured loans but may participate in repo transactions so long as these transactions may be fairly characterized as securities purchases and sales.[5] Any general characterization of repos as secured loans could, therefore, jeopardize the continued participation of these investors in the repo market. This would deprive the market of much of its depth and, therefore, much of its liquidity.

This depth and liquidity not only serve to lower the price of government securities; they are crucial to the monetary policy operations conducted by the New York Fed. *See Federal Open Market Committee v. Merrill*, 443 U.S. 340, 343 (1979). Indeed, repo transactions are the primary tool of the New York Fed in conducting these monetary policy operations.

[5] *See, e.g.*, N.Y. Const. Art. VII § 8 (McKinney 1993) (prohibition on state lending money to private parties); N.Y. Const. Art. VIII § 1 (McKinney 1993) (prohibition on municipalities doing same); N.J.S.A. Const. Art. 8 § 2 ¶ 1 (1993) (similar). *Cf. In re Lion Capital Group*, 49 Bankr. 163, 181-83 (Bankr. S.D.N.Y. 1985) (because of municipal charter restrictions, repo clearing bank should have known that accounts were meant to be segregated).

Sternlight Affidavit, ¶ 4; Ann-Marie Meulendyke, *U.S. Monetary Policy and Financial Markets* 45, 155-56, 170-72 (1989). Repos have been important throughout the postwar era. *See, e.g., Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System, 1951* at 107-08. Once again, statistics reflect this best. Table 1.17 of the April edition of this year's *Federal Reserve Bulletin* describes the Federal Reserve Open Market Transactions as of the end of 1993. 80 *Fed. Res. Bull.* at A10. Line 27 gives an approximate notion of the volume of the New York Fed's trading desk's repo transactions involving Treasury securities—half a trillion dollars for the year 1993. In contrast, the trading desk purchased outright only a gross 37 billion dollars of Treasury securities, as shown by line 22. The rough import of these numbers is clear—around 90 per cent of the New York Fed's open market transactions involve repos.[6]

II. This Case May be Decided Without Characterizing Repos.

This case may be decided without characterizing repos. Admittedly, most lower courts considering the amenability of repo income to state taxation pursuant to 31 U.S.C. § 3124 have performed the characterization exercise and have characterized repo transactions as, in essence, collateralized loans. *See, e.g., Andras v. Dep't of Revenue*, 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E.2d 439, 443-44 (2d Dist. 1987), *cert. denied*, 485 U.S. 960 (1988).[7]

[6] In fact, the power of the New York Fed to participate in the repo market derives in large part from the purchase-and-sale characteristics of repo transactions. 12 U.S.C. § 355(2); Sternlight Affidavit, ¶¶ 3-5.

[7] *See also, e.g., Department of Revenue v. Page*, 541 So.2d 1270 (Fla. App. D5 1989) (employing *Andras* factors); *Massman Constr. Co. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989) (employing a different test); *Citizen's Nat'l Bank of Waco v. United States*, 551 F.2d 832, 838 (Ct. Cl. 1977) (federal tax case). *See infra* note 10 (more cases).

Interestingly, one of these courts later recanted, calling its characterization a "dictum" when it realized that the characterization could have

Courts have done this because they tend to reason by analogy. Generally, state tax statutes do not cover repo transactions, but they do cover interest realized on loans. A court asked to decide whether the income from a repo is subject to state taxation will naturally analogize the repo to that which the law clearly covers—secured loans, for example.[8] This may be a reasonable treatment of state tax law but it is not a reasonable analysis under 31 U.S.C. § 3124.

The case law interpreting 31 U.S.C. § 3124 does not work by characterization. A state tax violates this section (and the Constitution) if it "imposes an intolerable burden on Federal obligations by threatening to diminish their value." *Am. Bank & Trust Co. v. Dallas Cty.*, 463 U.S. 855, 870 (1983); *see also First Nat'l Bank of Atlanta v. Bartow Cty. Board*, 470 U.S. 583, 596 (1985). "A state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). It is the existence (and perhaps magnitude) of this threat that is at issue here; not the proper characterization of repos.

III. The Nebraska Supreme Court Misapplied the Sternlight Affidavit.

Unlike many other courts, the Nebraska Supreme Court kept the preemption issue separate from its analysis of state

unfortunate state law consequences. *Compare Hammond Lead Products, Inc. v. State Tax Com'rs*, 549 N.E.2d 424, 429 (Ind. Tax. 1990), *aff'd*, 575 N.E.2d 998 (Ind. 1991) ("in effect . . . collateralized loans") with *Indiana Dep't of State Revenue v. Hardware Wholesalers*, 622 N.E.2d 930, 932 (Ind. 1993) (characterization "was dictum because the court was not required to classify such transactions, but only to determine whether such transactions really transferred ownership of the underlying securities.")

[8] This Court used a similar analysis to conclude that securities lending transactions are actually purchases and sales for purposes of a Federal transfer tax. *Provost v. United States*, 269 U.S. 443, 455-57 (1926).

tax law. *Loewenstein v. Dep't of Revenue*, 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, ___ U.S. ___, 114 S.Ct. 1215, 127 L.Ed.2d 562, 62 U.S.L.W. 3588 (1994). The Nebraska Supreme Court stated:

> [T]he state tax clearly imposes a burden on the market for federal securities. A review of the expert testimony of Sternlight makes it clear that a state tax on such income would diminish the market value and the investment attractiveness of federal securities, that the tax would impose a burden on the federal government's regulation of the nation's money supply, and that such tax would increase the costs to the federal government in financing the national debt.

Id. at 90, *id.* at 805. The *Loewenstein* court relied upon Mr. Sternlight's statements but appeared to have drawn some inferences from them that Mr. Sternlight did not intend and are unwarranted.

The context of Mr. Sternlight's statements is important. Mr. Sternlight's deposition was taken in connection with *Page*, 541 So.2d at 1270, a case raising issues similar to *Loewenstein*. This deposition was based on the Sternlight Affidavit and did nothing but ratify the Affidavit. The Sternlight Affidavit was filed by the New York Fed in 1986 as *amicus curiae* in the *BBS* case, which had nothing to do with state taxation of repo income.[9]

The Sternlight Affidavit does not mention taxes. Nor did Mr. Sternlight testify about taxes in his deposition. Mr. Sternlight addressed the charter restrictions alluded to above, and various commercial law characterizations of repo transactions. Sternlight Affidavit, at ¶¶ 3-8. Mr. Sternlight opined that certain improper characterizations of repos could be destructive. But Mr. Sternlight did not opine on the economic effect of state taxation of repo transaction income on the underlying

[9] The *BBS* court devised an appropriate treatment of repos in the context of commercial law and the Bankruptcy Code.

government securities, which is the ultimate issue to be addressed here.

IV. The Supreme Court Should Perform a Direct Section 3124 Analysis without Using the Sternlight Affidavit, and Without Characterizing Repos.

As argued above, characterization of repos is irrelevant to the 31 U.S.C. § 3124 inquiry. This Court must decide whether the tax is preempted because of its economic effect on the underlying governmental securities. In other words, it must decide whether a state tax on repo income has an effect on the price of government securities that rises to the level of a Section 3124 encroachment.

Not only is characterization of repos legally unnecessary, it is unwise. As Judge Debevoise found in the *BBS* case:

> The foregoing discussion leads to one inescapable conclusion: repos and reverse repos are hybrid transactions which do not fit neatly into either a secured loan or purchase and sale classification. There is no question that repo and reverse repo transactions have functional attributes which resemble collateralized loans. The initial taking of margin (the "haircut"), the right of substitution, and the "mark-to-market" provisions are undeniably secured loan characteristics not commonly found in purchase and sale transactions. . . . On the other hand, the repo buyer's unrestricted right to trade the securities during the term of the agreement represents an incident of ownership which does not pass to a secured lender in a collateralized loan transaction. . . . Clearly, any attempt to determine whether a repo or reverse repo transaction is more like a secured loan than a purchase and sale by weighing economic factors on a finely tuned balance scale would be an essentially formalistic and ultimately unproductive enterprise.

BBS, at 596-97.

The New York Fed recognizes that, despite Judge Debevoise's warning, many courts have "functionally" characterized repos in a variety of settings.[10] Except for one poor decision which ultimately led to enactment of 11 U.S.C. § 559,[11] the market so far has adjusted to these characterizations. The most important consideration is that a "functional treatment" of repos be consistent with market practice and expectations. Athough unwise and risky, characterization can be tolerated if the opinion is correct on the facts and carefully limited as to possible consequences.

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[10] Taxation: *See supra* note 7; *Everett v. Dep't of Revenue and Finance*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 320 Md. 352, 578 A.2d 192 (1990); *Borg v. Dep't of Revenue*, 308 Or. 34, 774 P.2d 1099 (1989); *Capital Preservation Fund, Inc. v. Dep't of Revenue*, 145 Wis.2d 841, 429 N.W.2d 551 (Wis. App. 1988); *In re Sawyer Estate*, 149 Vt. 541, 546 A.2d 784 (1987).

Insolvency law: *In re Mt. Pleasant Bank & Trust Co.*, 426 N.W.2d 126 (Iowa, 1988) (calling repos, through implicit functional analysis, security interests and discussing their perfection).

Securities law: *Drysdale*, 785 F.2d at 38.

Insurance policy coverage: *First Fed. Sav. & Loan Ass'n of Toledo v. Fid. & Deposit Co. of Maryland*, 895 F.2d 254 (6th Cir. 1990) (meaning of repos in bankers' blanket bond); *RTC v. Aetna Cas. & Sur. Co.*, 831 F.Supp. 610, 620 (N.D. Ill. 1993) (same).

[11] The bankruptcy court in charge of the Lombard-Wall securities firm insolvency made a preliminary bench ruling that repo transactions were collateralized loans for the purposes of the automatic stay provisions of the Bankruptcy Code. This bench ruling, never published, created tremendous market uncertainty, leading to ultimate enactment of Section 559 of the Code. These events are described in *BBS II*, 878 F.2d at 747-48.

Conclusion

For all the foregoing reasons, *amicus curiae* Federal Reserve Bank of New York urges this Court to decide this case on grounds that do not involve characterizing repo transactions. Better yet would be an explicit dictum recognizing Judge Debevoise's point that repos are *sui generis* and do not take well to characterization. If this Court must characterize repo transactions, the New York Fed urges this Court to limit its opinion to tax cases only.

Respectfully submitted,

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APPENDIX

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF NEW JERSEY

(Hon. Dickinson R. Debevoise)
Civ. No. 85-1728
Chapter 11

In the Matter of:
BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION,
Debtor.

Adversary Proceeding
No. 85-2103

SAUL S. COHEN, TRUSTEE OF BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION,
Plaintiff,

vs.

ARMY MORAL SUPPORT FUND, et al.,
Defendants.

Civ. No. 85-2224

In re:
BEVILL, BRESLER & SCHULMAN, INC.,
Debtor.

Adversary Proceeding
No. 85-5274

RICHARD W. HILL, TRUSTEE FOR THE LIQUIDATION OF BEVILL, BRESLER & SCHULMAN, INC.,

Plaintiff,

vs.

FIDELITY NEW YORK, F.A., et al,

Defendants.

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

AFFIDAVIT OF PETER D. STERNLIGHT

1. I am Executive Vice President of the Federal Reserve Bank of New York ("FRBNY") with responsibility for the Open Market Operations Function.

2. I have had experience at the FRBNY's open market trading desk since the 1960's and for the past six years I have been Manager of the System Open Market Account ("SOMA"). In that capacity, I have responsibility for a variety of types of transactions undertaken by the FRBNY open market desk for the account of SOMA. The object of those transactions is to adjust the level of bank reserves in order to achieve the Federal Open Market Committee's monetary policy goals. FRBNY also carries out transactions in the market on behalf of foreign central banks to aid them in their dollar investments.

3. Repurchase agreements involving United States Treasury issues and certain other agency issues are essential to the operations of the open market desk for reserve adjustments. In addition, the liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets. Repurchase agreements are unique vehicles for short-term, high-volume financing. As used in the market today, repurchase agreements are viewed generally as contracts for the sale of securities and their resale back to the original seller at a future date. An essential feature of this arrangement is that securities delivered under a repurchase agreement are freely transferable and unencumbered by restriction from previous transfers.

4. During 1985, the FRBNY conducted SOMA transactions in the market in the aggregate amount of $212 billion. Of these, 74 percent were repurchase transactions, and 17 percent were reverse repurchase transactions (known to FRBNY as matched sale-purchase agreements). Thus, only 9 percent of the 1985 SOMA market transactions conducted by the FRBNY were conducted without the use of repurchase or reverse repurchase agreements. Also during 1985, the FRBNY conducted $188 billion worth of transactions in the market on behalf of approximately 150 foreign central banks and other foreign official institutions. Of these, some 62 percent were repurchase transactions. Federal Reserve operations in the market on a single day through repos or reverse repos often come to $3-4 billion and have reached as high as 7.9 billion.

5. The FRBNY repurchase transactions are, by statute, structured and conducted as contracts for purchase-and-sale. The high volume of Federal Reserve open market operations requires the broadest possible repurchase market for government securities. It is doubtful that the FRBNY would have access to a market for repurchase agreements characterized as secured loans. Such a result could impair the FRBNY's ability to maintain appropriate levels of bank reserves from week to week, diminish the FRBNY's ability to achieve reserve

growth objectives, and possibly accentuate interest rate volatility.

6. Repurchase agreements are an important method for dealer financing of their inventories of United States government securities. The primary dealers typically underwrite a sizeable portion of new Treasury issues—35-75 percent—and rely heavily on temporary financing through repurchase agreements pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform this very useful underwriting function, thus adding to Treasury interest costs.

7. Repurchase agreements are a major vehicle in the market-making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions, the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants, which in turn increases the market for Treasury issues. If repurchase agreements were to lose their present characteristics of flexibility and liquidity, the dealer market—a critical element in the process of financing the national debt through Treasury issues—would be handicapped. More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency and the allocation of resources. Market participants would turn to less liquid forms of investment that would tend to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could add to average rate levels.

8. Repurchase agreements have proven to be invaluable to a wide variety of institutional investors, both public and private. A significant number of participants in the market are public entities who face constitutional, statutory, or regulatory restrictions on lending and borrowing activities, but can and do rely on repurchase agreements to achieve investment, cash management and liquidity needs. If repurchase agreements, with their present characteristics (including unencumbered

transferability of securities delivered under repo contract), and in their present form and as presently understood in the market (contracts for the sale and repurchase of securities) were unavailable to these participants in the market, the more costly financing alternatives would have adverse consequences for the entities involved, and their withdrawal from the government securities market as repurchase participants would adversely impact the market.

9. Repurchase agreements, as used and understood by the FRBNY in conformity with recognized and accepted market practice, are agreements for the transfer of securities with a simultaneously executed agreement to retransfer securities back to the original seller at a specified future date. They are structured and treated as sales and repurchases, unencumbered by any restriction from prior transfer that would impede further transfer. This treatment is essential to the purposes for which repurchase agreements are employed: high volume, short-term financing transactions.

/s/ PETER D. STERNLIGHT
Peter D. Sternlight

Subscribed and sworn
to before me this 11th
day of April, 1986
/s/ MARGARET M. MANUEL
MARGARET M. MANUEL
Notary Public

[ILLEGIBLE]
Notary Stamp